Economic Outlook

Third Quarter 2018

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“Chimerica” Becomes a Chimera

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SEI recently released its third-quarter Economic Outlook. A summary of the conclusions is provided below:

- The ratcheting-up of trade-war tensions between the U.S. and China has become the leading preoccupation of investors. Whatever happens between the two countries will likely have global implications across economies and financial markets. China and America together accounted for 42% of world nominal gross domestic product last year.

- The Chinese renminbi has fallen sharply against both the dollar and a broader basket of currencies. The weaker currency partially offsets the impact from the first round of tariffs imposed by the U.S. The competitiveness of Chinese exporters against other countries has, of course, improved as a result of currency devaluation.

- On the downside, the weak Chinese currency makes it almost certain that the Trump Administration will increase the tariff rate to 25% at the beginning of January. It also could raise the ire of other big importers of Chinese goods, perhaps making it easier for the U.S. to enlist the support of other World Trade Organization members in its attempt to sanction China over unfair trading practices.

- The U.S. is in strong shape economically. Although nobody wins in a trade war, even those White House advisors who hold a pro-trade bias believe that the U.S. will get hurt less. Investors appear to have reached the same conclusion. While the U.S. flirts with new all-time highs, China has fallen into bear market territory.

- As the trade war with China heats up, the Trump Administration has become more conciliatory toward other countries with which it has picked fights. With regard to the North American Free Trade Agreement, broad agreement has been reached with Mexico and Canada. The threat of tariffs on European and Japanese autos and auto parts has been shelved. This may represent a realization by the White House that it’s better to gain allies in its battle against China than fight on multiple fronts.

- The fundamental outlook remains favorable for U.S. equities, despite trade-war concerns and the rising trend in interest rates. Tax cuts, deregulation and strong revenue growth have provided an ideal backdrop for equities to appreciate, but performance could be constrained if earnings estimates fade in the event economic growth slows unexpectedly or profit margins falter as a result of the increasing tariffs on tradable goods. SEI views the risks to the U.S. stock market as evenly balanced and not yet tilted to the downside.

- Besides rising trade tensions with China, we see the Federal Reserve as another potential threat to the U.S. equity bull market. SEI agrees with the Fed’s view that the funds rate is still below the so-called neutral rate of interest, above which the stock market has historically run into trouble. The question is how high the federal-funds rate will ultimately go

- One can argue about whether the valuations embedded in the U.S. equity market are high, especially when measured against other global stock markets. A sharp rotation out of large technology companies could be somewhere down the road. SEI equity portfolios certainly tilt in the direction of more value-oriented companies and industries.

- Predicting the future is a hazardous venture most of the time. In view of the uncertainties facing investors at the present time, the prediction game is, perhaps, even more challenging. Accordingly, we believe in a diversified approach to investing. Although maintaining exposure to risk assets may feel uncomfortable, for investors with long time horizons, it pays to keep in mind that mistiming entries and exits into and out of equities can be costly. At this stage, mistiming one’s exit is the greater concern.

A full-length paper is available if you wish to learn more about this timely topic.

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